No. 3011.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of the PHOENIX HARDWARE COMPANY, a corporation, Bankrupt, J. B. LONG, J. W. LONG, MARGARET M. LONG and M. WEST,

Appellants,

vs.

CHARLES B. CHRISTY, as Trustee of the ESTATE OF PHOENIX HARDWARE COMPANY, a corporation, Bankrupt,

Appellee.

Brief for the Appellants.

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Filed

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BRIEF FOR THE APPELLANTS.

This is an appeal from an order made by the Honorable William H. Sawtelle, Judge of the District Court in and for the District of Arizona, on the 2nd day of March, 1917, affirming four certain orders and decrees theretofore entered by F. A. Larson, Referee of said court, each dated March 15, 1916, levying an

assessment of thirty-three (33) per cent. on each share of the capital stock of the Phoenix Hardware Company, a corporation, bankrupt, owned and held by the appellants herein, and wherein and whereby said appellants were given thirty (30) days from the date of said orders within which to pay said assessments, and amending the orders of the referee by making the obligation created by said orders joint and several (Tr., p. 105).

The facts are briefly these:

The Arizona Hardware and Vehicle Company was bankrupt and one J. B. Long, who was the manager of the said Company and entirely familiar with its stock, bought its stock of hardware merchandise for which he and M. West paid jointly ten thousand ($10,000.) dollars, to be exact not less than nine thousand nine hundred and fifty ($9,950) dollars (Tr., pp. 44, 58).

This stock was new, clean stock and was fully of the wholesale value of $20,000 and of the retail value of from $29,000 to $30,000 (Tr., pp. 48, 49). This stock was purchased on the 9th day of March, 1907, J. W. Long paying $1500 on account on that day (Tr., 92).

Thereafter the Phoenix Hardware Company was incorporated to wit: on March 19, 1907 (Tr., 84-88). J. B. Long and M. West, after the incorporation of the said Company, sold to the Company this stock of merchandise which they had purchased from the

Arizona Hardware and Vehicle Company the entire capital stock of the Phoenix Hardware Company being issued to them in payment therefor (Tr., 46). The 500 shares of the stock of the said Company was issued to Long and West in the following proportions: 250 shares to West, 130 shares to J. B. Long, 80 shares to J. W. Long and 40 shares to Margaret M. Long, J. W. Long's half of said capital stock being divided between himself and the members of his family.

At the time of the sale of this merchandise to the Phoenix Hardware Company and the issuance of this stock in payment therefor, the said Phoenix Hardware Company had no assets of any kind and no subscriptions had ever been made to the stock of the Company (Tr., 50). After the incorporation of the Company J. B. Long, J. W. Long and M. West became the Board of Directors and continued to be such board of directors for seven years or more or until on the 24th day of October, 1914, the Phoenix Hardware Company was adjudicated a bankrupt (Tr., 15).

More than one year after the date of the adjudication of said Company as a bankrupt, to wit: on the 25th day of October, 1915, Charles B. Christy, the trustee in bankruptcy, filed a petition with the referee in bankruptcy praying for an order directing him to make an assessment and call upon the unpaid subscriptions to the stock of the said bankrupt for the purpose of paying its debts (Tr., 1-9), to which petition the

appellants demurred on the ground that the said petition did not state facts sufficient to authorize the court to levy such assessment; also pleading in bar the Statute of Limitations of Arizona; denying that they had ever subscribed for any stock of the Phoenix Hardware Company and defending and setting up the acquisition of the number of shares of capital stock owned by them through a sale to the Phoenix Hardware Company of a stock of merchandise of the value of $20,000 (Tr., 10-11-12).

After testimony taken, appellants made a motion to dismiss the petition which was denied (Tr., 80).

The referee thereafter made his findings of fact in favor of the trustee and against the appellants, holding that the said appellants had subscribed to the stock of the Phoenix Hardware Company, M. West for 250 shares, J. B. Long for 130 shares, J. W. Long for 80 shares, and Margaret M. Long for 40 shares; and that said subscribers had paid on said subscriptions at the rate of 20 per cent. of their par value or $20 per share and that the said subscribers had paid for the entire capital stock of the said company the sum of $10,000 which the said Phoenix Hardware Company, through its officers and agents, had used in the purchase of a stock of goods from the Arizona Hardware and Vehicle Company, paying therefor the sum of $10,000; and that there was due 80 per cent. of the par value of said stock from each of said subscribers; and made four separate orders, holding respectively

that M. West was liable in the sum of 33 per cent. of the par value of 250 shares of the stock of the Phoenix Hardware Company, subscribed for by her, less $5,000 paid thereon, or in the sum of $3250; that J. B. Long was liable in the sum of 33 per cent. of the par value of 130 shares of the stock of Phoenix Hardware Company subscribed by him less $2600 paid thereon or in the sum of $1690; that J. W. Long was liable in the sum of 33 per cent. of the par value of 80 shares of the stock of thePhoenix Hardware Company subscribed for by him less $1600 paid thereon or in the sum of $1040; and that Margaret M. Long is liable in the sum of 33 per cent. of the par value of 40 shares of the stock of said Phoenix Hardware Company subscribed for by her and less $800 paid thereon or in the sum of $520 (Tr., 13-23).

Thereafter the appellants herein made an application to the District Court of the United States for the District of Arizona for a review of the orders of the referee, assigning as error all of the material findings of fact of the said referee (Tr., 92-95).

A hearing was had by the Court upon the certificate of the referee and on the petition for review of the order made by appellants and thereafter the court made its order affirming the order and decree of the referee and amending the same so as to make the obligation created by said orders and *decrees joint and several* instead of several (Tr., 105-6).

From this order of the court the appellants take this appeal and assign the following errors upon which they will rely for the reversal of the order:

ASSIGNMENT OF ERRORS.

The District Court of the United States of Arizona in making and entering the order of March 2, 1917, affirming the four orders and decrees of the Referee in Bankruptcy of said Court, entered herein on the 15th day of March, 1916, levying an assessment of thirty-three per cent. on each share of said respondents, and ordering the payment thereof, is erroneous in each and all of the following particulars:

1. That the said Court erred in affirming the orders and decrees of the said Referee ordering and adjudging as insufficient the response of these respondents to the rule filed herein on November 3, 1915.

2. That the said Court erred in affirming the orders and decrees of the Referee adjudging that respondents subscribed and did not fully pay for the number of shares of stock of said bankrupt corporation, as set forth in said orders, and further decreeing that respondents are liable in the sum of thirty-three per cent. of the par value of said stock less the amounts as found in said decrees to have been paid thereon, and ordering the payment thereof, for the reason that as fully appears from the evidence taken before the Referee in said matter, the respondents never subscribed for any of the stock of said corporation, but

that respondents became stockholders in said corporation by the sale to it of a certain stock of merchandise in consideration for said capital stock.

3. That said Court erred in affirming the orders and decrees of the Referee adjudging that the book accounts remaining in the hands of the trustee of said bankrupt as assets of said estate are not collectible, for the reason that the evidence taken before the Referee in said matter shows that no effort has been made by the trustee to collect such book accounts.

4. That the said Court erred in affirming the orders and decrees of the Referee adjudging that the original and only subscribers to the stock of said bankrupt corporation are the respondents herein, for the reason that the evidence taken before the Referee in said matter does not show that these respondents ever subscribed for any of the stock of said bankrupt corporation.

5. That the said Court erred in affirming the orders and decrees of the Referee adjudging that each of the respondents have paid upon said subscriptions at the rate of twenty per cent. of their par value, or twenty dollars per share, and that there remains unpaid on each and all of said subscriptions eighty per cent. of their par value, or eighty dollars per share, for the reason that the evidence taken before the Referee in said matter shows that there never was any subscription to said capital stock by respondents, but that, on the contrary, respondents acquired their stock by

the sale to said corporation of a stock of merchandise in consideration for the transfer to respondents of the entire capital stock of said corporation, and that there is no evidence to show that anything remains due from respondents to said corporation in consideration for said stock.

6. That the Court erred in affirming the orders and decrees of the referee adjudging that respondents paid for the entire capital stock of said bankrupt corporation the sum of ten thousand dollars, and that with said sum the said bankrupt corporation purchased a stock of goods from the Arizona Hardware and Vehicle Company and paid therefor the sum of ten thousand dollars, for the reason that the evidence taken before the Referee in said matter shows that respondents did not pay any money to said corporation in consideration for the entire capital stock thereof and that said corporation had no money with which to purchase said stock of merchandise from the Arizona Hardware and Vehicle Company, but that the respondents purchased said stock of goods from the Arizona Hardware and Vehicle Company before the incorporation of the Phoenix Hardware Company, and held title to the same until the incorporation of said company, and then sold and delivered said stock of goods to said Company in consideration for the transfers to them of the entire capital stock of said company.

7. That the said Court erred in affirming the orders and decrees of the Referee adjudging that by

agreements made at the time respondents subscribed to the capital stock of the bankrupt corporation, respondents by agreement were credited with the unpaid balance of the par value of their said subscriptions by discount, and the stock account between said bankrupt corporation and respondents balanced thereby, for the reason that the evidence taken before the Referee in said matter does not show any such transaction or transactions.

8. That the said Court erred in affirming the orders and decrees of the Referee in adjudging that the facts set forth in said orders of said Referee were in fact a representation to the public by the officers, managers and agents of said bankrupt corporation that all its capital stock had been subscribed for and had been paid in full, for the reason that the evidence taken before the Referee in said matter does not disclose any such representations, or any facts amounting in law to such representations.

9. That the said Court erred in affirming the orders and decrees of the Referee, for the reason that said orders and decrees so entered by the Referee are void, because the petition upon which said orders and decrees were based does not state facts sufficient to authorize this Court to levy an assessment upon the capital stock of said bankrupt corporation belonging to respondents.

10. That the said Court erred in affirming the orders and decrees of the Referee, for the reason that

said orders and decrees so entered by the Referee are void, because the petition upon which said orders and decrees are based upon its face shows that if there was any indebtedness of respondents to the corporation upon the capital stock of said corporation owned by respondents, such indebtedness is barred by the statute of limitations of the State of Arizona, to wit, Paragraphs 711 and 714, Revised Statutes of Arizona, 1913.

11. That the said Court erred in amending the orders and decrees of the Referee so as to make the obligation created by said orders and decrees joint and several, for the reason that the liability of a stockholder in a corporation for the unpaid balance upon his subscription for capital stock is a several liability only.

12. That the Court erred in affirming the orders and decrees of the Referee, for the reason that the facts found by the Referee in making and entering such orders and decrees, and upon which such orders and decrees were based are contrary to the evidence introduced at the hearing before the Referee.

ARGUMENT.

The position of appellants indicated by the errors assigned is this:

1. That no subscription of stock was ever entered into by appellants or any one of them; that the corporation had no subscribers.

2. That if, as claimed by appellee, there was a stock subscription as a matter of law, any liability for the alleged unpaid amount thereon would be several, instead of joint and several; and such liability, if any, was barred by the statute of limitations long before the company became bankrupt; or if not so barred as to creditors was barred as to them at the date of instituting the proceedings for the assessment of the stock of appellants.

An examination of the evidence will show an entire absence of any subscription on the part of any one of the appellants to the stock of the bankrupt corporation. The facts show that J. B. Long was one of the purchasers of the stock of merchandise from the Arizona Hardware & Vehicle Co. (J. B. Long paying on account of the contract of sale $1500. on March 9, 1907, Tr. 92), M. West joining with him in the purchase of the same. That some twelve days subsequent to such purchase said J. B. Long and his son, J. W. Long, filed articles of incorporation of the Phoenix Hardware Company (Tr., 83-88).

It appears from the uncontradicted testimony of J. B. Long that $10,000. was paid for this stock of merchandise and fixtures (Tr., 48) or possibly $50. less than this sum (Tr., 58). The stock was clean and new and its inventory value at wholesale was a little over $20,000., its retail value being $29,000. or $30,000. (Tr., 48-9).

After the company was incorporated on March 19, 1907, all of this merchandise, as we have stated, was sold by J. B. Long and M. West to the company in the company issuing its entire capital stock to J. B. Long and M. West in payment therefor, equally to be owned by them and the stock was issued as fully paid. J. B. Long testified he had his one-half issued to various members of his family, some to him, to his son and to his wife (Tr., 52). The Longs and M. West became officers in the company, which proceeded to do business and continued doing business for seven years, or until October 24, 1914, when it was adjudged a bankrupt. No stock subscriptions were ever signed or entered into verbally. No agreement was ever entered into as to the taking of any stock (Tr., 42). The stock was issued to the appellants in payment for the fixtures and merchandise sold.

We submit that the finding of the referee, affirmed by the Court that "the *original* and only *subscribers* to the stock of said company and the amount *subscribed* for by each on the 19th day of March, 1907,

are the following: M. West, 250 shares; J. B. Long, 100 shares; J. W. Long, 80 shares; Margaret M. Long, 40 shares"; and the further finding "that each of said *subscribers* have paid on said *subscription* at the rate of 20 per cent. of their par value, or $20. per share and there remains unpaid on each and all of said subscriptions 80 per cent. of their par value, or $80. per share" is without any basis in fact (Tr., 16). Assignments of Error, 2, 4, 5, 7, 9.

It is only upon the theory that the transaction whereby respondents obtained their stock in the bankrupt company, is a "legal" or "constructive" fraud, or, in other words, "fraudulent per se," that the trustee seeks to hold them personally liable for the debts of the bankrupt. There is no allegation or proof of actual fraudulent intent, and so, if the trustee's contention is to be sustained it must be solely upon the theory that the transaction between appellants and the company was a subscription for $50,000. worth of the capital stock of the company upon which a payment in merchandise of the value of $20,000. was made, and that under the so-called "trust fund doctrine" appellants are liable to creditors to the extent of the unpaid balance of the subscription.

The allegations of the petition are wholly insufficient, in the light of the evidence adduced by the trustee upon the hearing, to support a finding in his favor, the *allegations* and the *proof* being wholly at variance. The allegations are that appellants *sub-*

scribed for the capital stock of the bankrupt company and *made partial payments in cash thereon* (Par. VIII of petition Tr., 3), that the unpaid balance thereof was "credited by discount and the stock account between the said bankrupt corporation and said subscribers was balanced by such discount" (Par. IX of Petition, Tr., 5). The proof offered disclosed an entirely different transaction from the allegations of the petition, namely, a sale to the corporation, as we have shown, by appellants of a stock of hardware of the actual value of $20,000.00 for the entire capital stock of the corporation. No motion having been made to amend the petition to conform to the proof, appellants were entitled to a dismissal of the petition upon their motion.

However, even though the petition be considered as amended in that respect, appellants contend that they are entitled to its dismissal on the ground that the state of facts disclosed by the evidence adduced upon the hearing did not warrant the Court below in ordering a call and assessment upon the stock of the corporation, for the following reasons, to-wit:

1. It is shown that there were assets belonging to the bankrupt at the time of the adjudication, more than sufficient in value to pay the outstanding debts of the bankrupt, but that, through no fault of appellants, and wholly by reason of the neglect of the creditors and of the trustee in bankruptcy, these as-

sets have been permitted to become worthless, or nearly so (Testimony of Christy, Tr., 58-68).

2. There having been no "subscription" for the stock of the company, there was no agreement that appellants would pay anything for it beyond what they gave in exchange for it, and consequently there was no contract or agreement to pay balance on any subscription price which a court of equity can enforce (Tr., 42).

3. The contract must either stand or fall in its entirety. If the transaction was in fraud of creditors, the creditors cannot avail themselves of it by partaking of its fruits in the way of dividends paid from the sale of the merchandise given by appellants for the stock of the corporation and at the same time demand that appellants pay to them the balance of their claims out of their pockets. To do so would be contrary to the maxim that "he who seeks equity must do equity."

4. The trustee should not prevail unless it be affirmatively shown that the creditors of the bankrupt company extended credit to it without knowledge of the facts and circumstances under which appellants obtained their stock, and further that in so extending credit they relied upon representations that the entire capital stock of the corporation was fully paid up. The petition contains such an allegation (Tr., 5), but

no evidence was adduced upon the hearing in support thereof.

5. And so we repeat, the only theory upon which the trustee seeks to hold appellants liable for the debts of the bankrupt, is that the transaction whereby they obtained their stock was actually a contract of subscription—$20,000.00 worth of merchandise being paid upon the subscription price and the balance remaining unpaid being, as to subsequent creditors, a "trust fund" applicable to the payment of their claims. But even if this be true, we contend that appellants cannot at this late day be called upon to pay the subscriptions in the absence of any fraudulent agreement with the corporation whereby it was understood that they were not to pay them (and the evidence does not reveal any such understanding), for the reason that by the terms of the articles of incorporation of the bankrupt company "all subscriptions for the capital stock of said corporation shall be paid in to the corporation within thirty days from the time such stock is subscribed for" (Tr., 85). The transaction whereby appellants acquired their stock occurred on March 19th, 1907; so, even if such transaction is to be treated as a subscription for stock, such subscriptions were due and payable without further call within thirty days from March 19th, 1907, to-wit: April 18th, 1907, upon which date the statute of limitations commenced to run and has long since barred the collection of the debt; or if it be held that

the statute begins to run from date of adjudication of insolvency, it is still barred, as the trustee did not institute this proceeding in time.

I.

The Court erred in affirming the orders and decrees of the referee adjudging that the book accounts remaining in the hands of the trustee as assets of the bankrupt estate were not collectible for the reason that the evidence taken before the referee in said matter shows that no effort had been made by the trustee to collect such book accounts (Assignment of Error, 3).

No attempt was made by the receiver in the State receivership nor by the trustee in the Court of Bankruptcy to collect the outstanding bills receivable. All the trustee did in carrying out his trust which made it incumbent on him to collect all assets was to make some inquiries through local collectors and take their judgment that bills amounting to some $4,000 were uncollectible. All that was collected by both the Receiver and the Trustee was some $631.81 (Tr., 62), The major portion of these bills were allowed to outlaw (Tr., 66) and the amounts thereof thereby lost to the creditors through failure of the Trustee to prosecute suits for the recovery of the amounts due. It is well known that where creditors fail to pay their accounts, when prodded thereto by an action at law, the coin is forthcoming.

"This is a trustee's first duty vested with the title

of the bankrupt; he is also the representative of the creditors. He is further a quasi officer of the court. He must proceed to collect and reduce to money the property . . . under the direction of the Court and close up the estate as expeditiously as is compatible with the best interests of the parties. This he may do by, for instance, *collecting* accounts, even by suit. . . ."

Collier on Bankruptcy, Sec. 47, p. 36,607;
Remington on Bankruptcy, Vol. 1, Sec. 907;
In re Stein, 94 Fed., 124.

The purpose of the Bankruptcy Act is to enable or to compel a debtor who has become involved financially to turn over all his assets to his creditors that they may make the most out of them in satisfaction of their claims. And when assets are thus turned over to creditors the bankrupt has a right to expect that they will be so handled that the returns thereon will be as great as may be consistent with all the circumstances under which it may be necessary to dispose of them. Outstanding accounts due to a bankrupt are assets in every sense of the word and the trustee must use due diligence to realize upon such accounts the same as upon other assets of the estate. A trustee in bankruptcy is liable for gross negligence in the administration of the estate, and we say that for the trustee in this case to sit idly by and to permit $4,000.00 worth of accounts belonging to the estate to become barred by the statute of limitations without making any determined effort to collect them

beyond obtaining the opinion of various collection agents as to their collectibility (Tr., Test. of Christy, 58, 68; Shedd, Tr., 68-77; Taylor, Tr., 77-79), is gross negligence, especially in view of the testimony given by one of the collection agents upon the hearing that in his experience 75% of accounts of this character are collectible if suit is brought upon them (Tr., 77).

II. III.

It is conceded that if the trustee's contention be sustained, it must be on the theory of common law liability—and such must be the case, for the Arizona statutes contain no restriction upon the method or manner of issuing the capital stock of corporations, leaving such regulations entirely to the corporation itself (Par. 2100, subd. (3), Rev. Stat. Ariz., 1913). To be sure, par. 2109 of the Arizona Statutes provides that "nothing herein shall exempt the stockholders of any corporation from individual liability to the amount of the unpaid installments on the stock owned by them," but such provision is merely declarative of the common law. And so it is only on the theory of the common law liability that the capital stock of the bankrupt company standing in the name of these appellants is sought to be assessed.

It is clear from the evidence adduced upon the hearing that there was no subscription made by appellants for their stock, and that they acquired it through the sale of a stock of merchandise to the

company and in payment therefor. Therefore we say there is no agreement on the part of appellants to pay a balance on any subscription price which a court of equity can enforce.

The record speaks for itself and indicates one of the usual and ordinary methods employed daily in business life in the incorporation of companies. The statute does not insist upon subscriptions to the stock nor prohibit the payment in stock for property. It was therefore in form to organize the corporation without subscriptions and then purchase property and pay therefor in stock.

The officers of the company were within the powers of their charter when they issued the capital stock of the company in payment for merchandise and fixtures for, by Article III of the Articles of Incorporation, it is provided that "the Board of Directors of said Company may accept merchantable hardware at such prices as they may deem proper in part or full payment for any subscriptions to the stock of this corporation" (Tr., 85).

The fact that the property turned over was valued at less than par, where the procedure was followed in entire good faith, and untainted with actual fraud, will not render the stockholder appellants liable for the difference between the value of the stock at par and the amount turned over in property. There was no agreement to buy stock, but to sell merchandise.

There are no allegations of fraud and there was no proof of fraud.

The common law doctrine with respect to property taken by a corporation at an over-valuation in exchange for its capital stock is well stated in the Sixth Edition of Cook on Corporations, at paragraph 46:

> "At common law it is well settled that corporate creditors cannot hold stockholders liable on stock which has been issued for property, even though the property was turned over to the corporation at an agreed valuation which was largely in excess of the real value of the property. There have been cases which refuse to follow this rule, but it is clearly established by the great weight of authority. The reason of the rule is that if the payment by property was fraudulent, then the contract is to be treated like other fraudulent contracts. It is to be adopted in toto, or rescinded in toto and set aside. Both parties are to be restored as nearly as possible to their original positions. The property or its value is to be returned to the person receiving the stock, and he must return the stock or its real value. In New York and in England, as stated above, at common law the stockholder is not liable at all to corporate creditors, even though the overvaluation was gross and clearly known so to be. The remedy is rescission, and not the making of *a new contract by the court.*"

> "At common law there is no contract, express or implied, to pay to the corporation or to corporate creditors the par value of stock which is issued for property. Not only is there no such contract, but there is no implied fraud even though the property was overvalued. If there is express fraud the law provides ample remedies, but such

> a fraud must be clearly proven and is not implied from proof that the property was worth less than the par value of the stock."

In the case of *Coffin* v. *Ransdell,* 110 Ind., 417, the foregoing statement of the common law rule is upheld, the Court therein saying:

> "Suppose it to be true that, in consummating the arrangement, the property of Unthank & Coffin was turned in to the corporation at an overvaluation, and that the defendant and the other corporators participated in the alleged wrong. The transaction was the result of an agreement which the parties had the right, as between themselves, to make. . . . Shall (defendant) be capriciously punished by being made liable *ex contractu* upon a contract which he never made? If the defendant has participated in a fraud whereby the creditors of the corporation who exercised ordinary business sagacity have suffered damage, whatever redress such creditors may now obtain, while their representative retains the defendant's property, must be sought by an action *ex delicto.*"

And in *Horton* v. *Sherill-Russell Lumber Co.,* 143 S. W. 1053 (Ky.), the Court quoted with approval the text of *Cook on Corporations* as set forth above, and held that no recovery could be had at common law in a similar case.

In *Seaboard etc. Bank* v. *Slater,* 117 Fed. 1002, the Court held that stock given as a bonus does not render the holder liable to creditors for the par value thereof, "he not having subscribed for it or agreed to

" pay for it, and there being no proof that any cred-
" itor was injured thereby."

A distinction must be drawn between the classes of cases which have been decided under various statutory provisions and those decided at common law. Many cases can be found where stockholders have been required to pay the difference between the par value of stock received by them for property and the actual value of such property, but in by far the majority of such cases the requirement has either been based upon the provisions of *some statute* or upon allegation and proof of *actual fraud* perpetrated upon creditors by reason of the transaction. In *Clark* v. *Beaver,* 139 U. S. 96-35, L. ed. 88, Chief Justice Harlan said:

> "If the legislature had intended that the acquisition of stock at less than its face value should be conclusive evidence in every case that the stock, as between creditors and stockholders, is 'unpaid' it would have been easy to so declare, *at has been done in some of the States.* If such a rule be demanded by considerations of public policy, the remedy is with the legislative department of the government creating the corporation. A rule so explicit and unbending could be enforced without injustice to anyone, for all would have notice from the statute of the will of the Legislature. It is not for the courts by mere interpretation of a statute, not justified by its language, to accomplish objects that are within the exclusive province of legislation. *If,* when receiving the 910 shares of stock in payment of his portion of the claim of $70,000 against the railroad company, *Greene had*

> *supposed that he would thereby become liable to account to creditors for its full face value* without regard to the real value of the stock, and whether the corporation subsequently became bankrupt or not, *he certainly would not have taken it.*"

And so in the case at bar, if these appellants, when receiving their stock in exchange for the merchandise, had supposed that they would thereby become liable to creditors for its full face value without regard to the real value of the stock, they certainly would not have taken it.

In the case of *Clark* v. *Bever, supra,* plaintiff in error urged that the previous decisions of the Supreme Court of the United States required them to hold that a stockholder taking stock in exchange for property at an overvaluation is bound to creditors for the face value of the stock, but the Chief Justice said that *in all those cases there was an actual subscription* of a given amount—cases of promises to pay the company the amount subscribed, not of sales by it. In the case at bar there are no promises by appellants to pay anything. The only contract was the sale or exchange of the merchandise for the stock and for this Court to hold appellants liable as for an unpaid balance on subscriptions of stock, is to make an entirely different contract of the transaction.

This Court must be governed by the decisions of the Supreme Court of the United States in determining this question, and we insist that in no case similar

to the case at bar has that Court undertaken to make a *new contract between* the parties and then to *enforce it.*

IV.

It is only when fraud enters into a transaction of this kind that the stockholders can be held responsible. And the fraud must be "actual" fraud, not "constructive." See *Dupont* v. *Felden,* 42 Fed., 87, wherein it was held that a stockholder was not liable for the difference in value of land taken at a great overvaluation where there was no *actual* fraud in the transaction. As laid down in *Cook on Corporations, supra,*

> "Not only is there no such contract but there is no implied fraud even though the property was overvalued. If there is *express* fraud the law provides ample remedies, but such fraud must be *clearly proven* and is *not implied* from proof that the property was worth less than the par value of the stock."

This is the true rule to be followed in the absence of any statutory provisions to the contrary, and in Arizona we have seen that there are no such statutory provisions. That this is the rule is amply demonstrated by the following authorities:

"Where full paid stock is issued for property,

there must be *actual* fraud to enable creditors to call stockholders to account."

Bank of Ft. Madison v. *Alden,* 129 U. S., 372-32 Law Ed., 725.

In *Cort* v. *Amalgamating Co.,* 119 U. S., 343; 30 L. Ed., 420, the Court say on this subject:

"The plaintiff contends, and it is the principal basis of his suit, that the valuation thus put upon the property was illegally and fraudulently made at an amount far above its actual value . . . that the articles had no market or actual value, and, therefore, that the capital stock issued thereon was not fully paid, or paid to any substantial extent, and that the holders thereof were still liable to the corporation and its creditors for the unpaid subscriptions. If it were proved that *actual* fraud was committed in the payment of the stock and that the complainant had given credit to the company from a belief that its stock was fully paid, there would undoubtedly be substantial ground for the relief asked. But where . . . the shareholders honestly and in good faith put in property instead of money in payment of their subscriptions, third parties have no ground of complaint. . . . But where full paid stock is issued for property received, there *must be actual fraud in the transaction to enable creditors of the corporation to call the stockholders to account."*

In *Lake Superior Iron Co.* v. *Drexel,* 90 N. Y., 87, where certain patents had been taken for the price of $2,500,000. in stock, the trial court held that the real question was whether the property was taken at a higher valuation than it was worth, *with a fraud-*

ulent purpose with the intent of evading the provisions of the statute, thereby placing the question of fraud upon the jury and not from the mere fact of knowledge of overvaluation. There the Court said that it would not be stated as a matter of law that the property transferred for the stock was not worth the nominal value of the stock or that the trustees did not believe that it was.

> "The company at the time (of the transaction) having no debts and everyone assenting to the transaction, *there being no proof of fraud,* it is legal and creditors cannot enforce liability."

Bruner v. *Brown,* 139 Ind., 600.

"Fraud must be charged and proved."

Clow v. *Brown,* 31 N. E. (Ind., 361).

> "This right is one existing not in favor of all creditors of a corporation, but in favor of a particular class only, viz., those *creditors who were defrauded by said transaction."*

Great Western etc. Co. v. *Harris,* 128 Fed., 321 (affirmed 128 U. S., 561).

> "Stock given as a bonus to a person loaning money to a coporation does not render the holder liable thereon, *he never having subscribed for it*

nor agreed to pay for it, and there being *no proof that any creditor was injured by the transaction.*"

Taylor v. *Walker,* 117 Fed., 737 (affd. 127 Fed., 108).

"Creditors trying to hold stockholders liable must show that they *became creditors on the faith that the stock was paid up.*"

Taylor v. *Walker, supra,* 117 Fed., 737 (affd. 127 Fed., 108).

There was no attempt to show, as alleged in the petition, any representations that the stock was fully paid up or that any one or more of the creditors relied upon such a condition in rendering credit to the corporation.

"Where a creditor of a corporation rendered services sued for without investigating the corporation's financial condition and did not rely on the fact that the stock of the corporation was fully paid, he was not entitled to enforce a statutory stockholders' liability for debts on the ground that the stockholders' subscription had been paid by a transfer of the property at an excessive valuation."

McBride v. *Farrington,* 131 Fed., 797 (affirmed 149 Fed., 114).

"Creditors of an insolvent corporation can not compel holders of fully paid up stock to pay the difference between its par value and the value of

property conveyed in payment of it, in the absence of fraud in the valuation of the property."

Graves v. *Brooks,* 11 Mich., 424, 75 N. W., 932.

"The fact that property purchased by a corporation with stock at its par value is taken at an over-valuation will not make the holder of such stock liable as for unpaid subscription until the transaction has first been impeached for fraud on the corporation."

Merchants & Mechanics Savings Bank v. *Coke Co.,* 51 West Virginia, 60, 41 S. E., 390.

Courts will treat as payment that which the parties have agreed should be such.

The contract made in this instance between the Phoenix Hardware Company and the appellants was not disadvantageous to the corporation. It had no assets. It had no subscriptions to stock. Its stock had no real or market value. The appellants chose to give it some value by turning over $20,000 worth of merchandise referred to, receiving in payment therefor the 500 shares of stock.

Are corporations to be controlled by any other rules than those controlling individuals in the making of their contracts? Are the courts to say to these appellants, "It is true you never subscribed for any stock. While it is true you turned over all this merchandise to the Phoenix Hardware Company, worth

in the neighborhood of $20,000, agreeing to sell the same for the 500 shares of the stock of the company, and the company agreed to purchase this merchandise and issue you all its stock for the same and did so," yet, after the contract has been in effect seven years, say to these appellants, "that was not your contract —your contract was to pay $50,000. for that stock, and you are liable for the difference between $50,000 and the real valuation of that merchandise and must pay it." Can the Court go this far in this case, when it appears that the whole proceeding was done in good faith, with no intent to defraud or mislead and substitute a new contract for that entered into by the parties?

> "A corporation may take in payment of its shares any property which it may lawfully purchase. Such a transaction is not *ultra vires* or void, but is valid and binding upon the original share takers and upon the corporation unless it is rescinded and set aside for fraud. While such a contract stands unimpeached, the courts *even where the rights of creditors are involved, will treat that as payment which the parties have agreed should be payment."*

Sec. 1341, *Thompson's Liability of Stockholders.*

In the case of *Kroenert* v. *Johnston,* 19 Wash., 96, the Court say:

> "Section 4262, Sec. 1. Ballinger's Code prescribes a liability upon the part of stockholders in

a corporation like this for the amounts subscribed by them. This relates to their contractual liability and *if there has been no subscription, there is no contract to pay the corporation or its creditors anything in cases where the shares of stock were originally issued as paid up.* This action is practically brought as or has resolved itself into one to enforce a contractual liability. . . . The fraud claimed bears more especially upon Johnston than upon the other defendants. The basis is that by subscribing for $5000. of the stock he contracted to pay that amount to the corporation. The alleged fraud consisted in turning in the real estate for a greater sum than its actual value. The only charge of fraud that could obtain against the other defendants was in permitting this real estate to be accepted or in agreeing to accept it for the price stated. As we understand the facts there was no real subscribing by them for any part of the capital stock. In obtaining it from Johnston they assumed no part of his contractual liabilities to the corporation or to the creditors under our statutes. As against them the action can only be maintained on the ground of an actual intentional fraud upon subsequent creditors of the corporation and there was no proof of such; and we think the same result follows as to Johnston under the proofs. *There was no showing that the corporation was formed with the design to issue any paper or obligations to third parties or to put any such afloat upon the market or to incur any indebtedness at all.* This was found necessary in the later prosecution of the business. . . .

"Without setting forth the testimony the most favorable view proved for plaintiff is that there *was an overvaluation of the real estate turned in as a partial payment, but that this was offered, agreed upon and accepted without any intention to defraud anyone;* the corporation being formed for

a legitimate and useful purpose. *While the records of its proceedings were not fully kept, and no formal resolution accepting the real estate was shown as of record, it was amply proven that such was the agreement and the proof was admissible, although the records were deficient. The mere fact of overvaluation does not establish a fraud in law as against Johnston, or, in other words, render him liable to a subsequent creditor for the difference between the actual value and the agreed value upon his subscribed liability. . . .*"

The conditions of this case are strongly similar to the one at bar, being a creditor's bill to enforce a liability of stockholders on the ground that the stock held by them had not been paid for up to the par value.

The Court there further says:

> ". . . Courts, *even where the rights of creditors are involved, will treat that as a payment which the parties have agreed should be a payment. This seems to us to be the more reasonable and equitable rule and sustained by the greater weight of authority.* There is no hardship in requiring a party who contemplates having dealings with a corporation, or of purchasing its outstanding obligations, to acquaint himself with the actual property it has. The fact that it was incorporated with a certain amount of capital stock, should make no difference *in the absence of a fraudulent dishonest purpose, as if organized for the object of issuing and floating its obligations with an apparently real but actually only a fictitious value.* A knowledge of the amount of its designated capital stock would afford little or no criterion to determine the amount of its assets if it had been fully paid in money. Its capital might be lost or

> impaired through legitimate business transactions and it would be just as reasonable to hold that it would be a fraud on creditors if it was not kept good and up to the stated amount."

It was incumbent on appellee to show that stock at time of transfer to appellants had a real or market value in excess of price paid.

The value of the fixtures and merchandise sold by appellants to the Phoenix Hardware Company had a real substantial value. It was worth over $20,000 at wholesale, or from $29,000 to $30,000 at retail, as appears uncontradicted from the evidence, and the stock of the Phoenix Hardware Company at the time had no value, as there was no subscriptions and no assets (Tr., 50).

> "Where the stock has no value when it is issued for property the creditors are not deprived of anything and cannot complain."

Cook on Corporations, Sec. 46, p. 124, Vol. I.

Where all the stock and a large quantity of bonds were issued by a railroad corporation to its contractor in payment for the construction of its road, the contractor is not liable to corporate creditors on the stock, even though the bonds without the stock were a sufficient consideration for building the road, unless the corporate creditors prove that the stock at the time of its issue had a real or market value.

Fogg v. *Blair, supra.*

In that case the U. S. Supreme Court say:

> *"If when disposed of by the railroad company, it was without value, no wrong was done to the creditors"* (p. 126).

V.

However, if this Court should hold with the lower court that the transaction between appellants and the company whereby appellants obtained their stock must be treated as a subscription, the statute of limitations must bar a recovery from appellants of the so-called "unpaid balance." This becomes apparent at the close of petitioner's case. No evidence of actual or express fraud having been adduced, the transaction, if fraudulent at all, could only be so "in law." Therefore it cannot be urged that the "fraud" was not discovered until the happening of the insolvency of the company and that the statute of limitations did not commence to run until then, for, there being no actual fraud, the whole transaction was open and above board and fully apparent to anyone dealing with the company.

Section 711 of the Revised Laws of Arizona, 1913, provides:

> "There shall be commenced and prosecuted within three years after the cause of action shall have occurred, . . . (1) Actions for debt where the indebtedness is not evidenced by a contract in writing. . . . (2) Actions for relief

> on the ground of fraud or mistake. The cause of action in such case not to be deemed to have accrued until the discovery by the aggrieved party of the facts constituting the fraud or mistake."

Section 714 Id. prescribes:

> "Action for debt, where the indebtedness is evidenced by or founded upon any contract in writing executed within this State, shall be commenced and prosecuted within four years after the cause of action shall have accrued and not afterward."

And so the "discovery of the fraud" having nothing to do with the time when the statute of limitations would commence to run, the only other circumstance which might prevent its running would be the failure of the company to issue a call for the unpaid balance of the subscription or an agreement between the company and the so-called "subscribers" that no call would ever be made. The evidence adduced by petitioner fails to show any such agreement, although alleged in the petition. Still, it might be said that there is no evidence so far to show any call by the corporation for the payment of the balance alleged to be due upon the subscriptions; but our contention is that the articles of incorporation themselves fix the time when subscriptions are due and payable, that is 30 days after stock has been subscribed for, and that therefore no call is necessary (Art. III, Tr. 85).

In the court below counsel for appellee laid great stress upon the opinion handed down by Mr. Justice

Woods in the case of *Scoville* v. *Thayer,* 105 U. S., 143; 26 Law Ed., 968, holding that the statute of limitations did not commence to run in that case until there was a demand for the payment of the balance of the subscription. We quote the following excerpts from that opinion:

> "It is well settled that when stock is subscribed for *to be paid upon call* of the company, *and the company refuses or neglects to make the call,* a court of equity may itself make the call."
>
> "Under such circumstances before there is any obligation upon the stockholder to pay *without an assessment and call* by the company, there must be some order of a court of competent jurisdiction, or at the very least some authorized demand upon him for payment."
>
> "In this case there was no obligation resting upon the stockholder to pay at all until some authorized demand in behalf of creditors was made for payment."

It will thus be seen from the reasoning of this opinion that if there had been an obligation on the part of the stockholder to pay the balance of the subscription, antedating the time limited by the statute, that the determination of the Scoville case would have been that the action was barred. And so we say that that case is determinative of the question here. In the case at bar the obligation to pay the subscription, assuming that there was a subscription, is fixed and determined by the articles of in-

corporation—no further call or assessment was necessary to make the obligation complete—and in the absence of any fraudulent agreement between the company and the "subscriber" to relieve the subscriber from the obligation (fraudulent as against creditors), the obligation to pay remained in effect and binding upon the stockholder until released by the lapse of time, when it cannot be revived.

Further conceding that the trustee in bankruptcy takes the place of the corporation and would have power to levy a subscription assessment for the benefit of creditors, we submit that he would be subject also to the bar of the statute, if as contended the statute of limitations in this regard begins to run only from the adjudication of insolvency.

Section 2109 of the Revised Statutes of Arizona provides that:

> "Nothing herein shall exempt the stockholders of any corporation from individual liability to the amount of the unpaid installments on the stock owned by them, or transferred to them for the purpose of defrauding creditors; and an execution against the corporation to that extent may be levied upon the private property of such individual or individuals."

This while affirming the common law and declaratory thereof is a statutory liability. And Section 709 of the Revised Statutes of Arizona provides that ". . . an action upon a liability created by statute—other than a penalty or forfeiture," shall be

commenced and prosecuted within one year after the cause of action shall have accrued.

The bankrupt corporation was adjudicated such on the 24th day of October, 1914 (Tr., 15), and the petition or complaint to recover said unpaid assessments was not filed until over a year later, to wit: on the 25th day of October, 1915 (Tr., 1-10).

So that even for argument sake, admitting liability on the alleged subscription, there was no authorized demand until after the bar of the statute had been interposed.

VI.

THE DEMURRER TO THE PETITION SHOULD HAVE BEEN SUSTAINED.

We rely upon the law as hereinbefore set forth in support of our contention that the demurrer to the petition should have been sustained (Assignment of Error I), and particularly call the Court's attention to the language used by Mr. Justice Harlan in the case of *Fogg* v. *Blair,* 139 U. S., 118; 35 Law Ed., 104.

> "While it was competent for the St. Louis, Hannibal and Keokuk Railroad Company, exercising good faith, to use its bonds and stock in payment for the construction of its road, it could not rightfully, at least as against creditors or stockholders, issue its stock to Blair and Taylor as full paid, without getting some fair or reasonable equivalent for it. What was such an equivalent *depends*

primarily upon the actual value of the stock at the time it was contracted to be issued, and upon the compensation which under all the circumstances, the contractors were equitably entitled to receive for the particular work undertaken or done by them."

"It is averred in the bill, and the demurrer admitted, for the purposes of the hearing below, that full and adequate compensation for the work done by Blair and Taylor was $12,000 per mile in the company's first mortgage bonds. Assuming this to be true, *if the stock issued to Blair and Taylor was of any considerable value at the time they received it,* or if the circumstances attending its delivery to them indicated bad faith upon their part or upon the part of the corporation, different questions would arise from those now presented. *But the bill contains no allegation whatever as to the real or market value of the stock.* . . . If when disposed of by the railroad company it was without value, no wrong was done to creditors by the contract made with Blair and Taylor. If the plaintiff expected to recover in this suit upon the ground that the stock was of substantial value, it was incumbent upon him to distinctly allege facts that would enable the court—assuming such facts to be true—to say that the contract between the railroad company and the contractors was one which, in the interest of creditors, ought to be closely scrutinized. He seems to have carefully avoided making any allegation as to the real or probable value of the stock, *and to have supposed that the court, in the absence of averment or proof to the contrary, would assume that it was worth par, or had substantial value.* As he impugned the good faith of the transaction between the company and the contractors, it was incumbent upon him to state the essential, ultimate facts up-

> on which his cause of action rested, and not content himself with charging generally, that what was done was 'colorable,' a 'fraud,' a 'breach of trust' and a 'scheme' by which Blair and Taylor were to get the stock without paying for it. These are *allegations of legal conclusions* merely, which a demurrer does not admit."

The allegations of the petition in the case at bar are so nearly similar in general terms to the allegations of the bill commented upon by the Court in the foregoing opinion that it seems unnecessary for us to add anything to such comments in support of our contention that the demurrer should be sustained. We therefore submit it without further comment.

VII.

The Court erred in amending the orders and decrees of the referee so as to make the obligation created by said orders joint and several instead of several.

Assuming *pro argumenti* that there was a stock subscription by appellants in this case, which we deny, the liability, if any, created thereby was an individual one and not joint and several.

Section 2109, Title 9, of the Revised Laws of Arizona, 1913, declares the common law liability of stockholders in ordinary corporations as follows:

> "Nothing herein shall exempt the stockholders of any corporation from individual liability to the

> amount of the unpaid installments on the stock owned by them or transferred to them for the purpose of defrauding creditors and an execution may be levied upon the private property of such individuals or individual."

By what process of reasoning the Court below arrived at the conclusion that the liability of appellants as found by the receiver was joint and several, is beyond our comprehension. If this be the law, then in an action to recover on a stockholder's liability for balance due on subscriptions to stock, every stockholder sued is, in addition to his liability to pay the amount due on his own contract of subscription, also liable to pay that of every other stockholder sued with him and against whom a judgment is obtained for unpaid stock subscriptions.

In this case if any one or more of these appellants is insolvent and unable to pay the amount found due on his alleged contract of subscription then the appellant who is able to pay must pay the alleged indebtedness of all who are so unable to pay. The mere statement of this proposition negatives it. The liability of these appellants assuming that the Court below was correct in holding them liable at all (which we deny) is not joint but is several, unequal and limited as to which each stands alone.

A judgment cannot therefore be rendered against the shareholders *jointly* to enforce this liability or against each *in solido* (10th Cyc., 679).

For the reasons given we submit that the order of the lower court affirming the orders and decrees of the referee should be reversed.

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